

Date: 5/25/2022

**Valuation of Securities (E) Task Force**

Thursday, June 9, 2022

3:30 p.m. – 4:30 p.m. ET / 2:30 p.m. – 3:30 p.m. CT / 1:30 p.m. – 2:30 p.m. MT / 12:30 p.m. – 1:30 p.m. PT

**ROLL CALL**

<b>Member</b>	<b>Representative</b>	<b>State</b>
Doug Ommen, Chair	Carrie Mears	Iowa
Scott A. White, Vice Chair	Doug Stolte	Virginia
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Marlene Caride	Nakia Reid	New Jersey
Adrienne A. Harris	James Everett	New York
Cassie Brown	Amy Garcia	Texas
Jon Pike	Jake Garn	Utah
Mike Kreidler	Tim Hays	Washington

NAIC Support Staff: Charles Therriault/Marc Perlman

**AGENDA**

1. Receive and Discuss a Memorandum of support from the Financial Condition (E) Committee to the Valuation of Securities (E) Task Force  
*(Doc. ID: 2022.005-01)*  
—Carrie Mears (IA), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment A
2. Receive and Discuss Comments on a Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Risk Measures to Investments Reported on Schedule D, Part One  
*(Doc. ID: 2021-053.01, 2021-053.02, 2021-053.03, 2021-053.04)*  
—Carrie Mears (IA), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment B  
Attachment B – 1  
Attachment B - 2  
Attachment B - 3
3. Receive a Proposed Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (P&P Manual) to Update the Role of the SVO Regarding Interpreting Accounting and Reporting  
*(Doc. ID: 2022-002-01)*  
—Carrie Mears (IA), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment C

4. Receive a Proposed Amendment to the P&P Manual to Update Part Four for NAIC Designation Category and Additional Price Points  
*(Doc. ID: 2022-003.01)*  
—Carrie Mears (IA), Eric Kolchinsky (NAIC), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment D
5. Receive and discuss an IAO Issue Paper on the Risk Assessment of Structured Securities - CLOs  
*(Doc. ID: 2022-004.01)*  
—Carrie Mears (IA), Charles Therriault (NAIC), Marc Perlman (NAIC) Attachment E
6. Receive a presentation from SSG on Modeling and Scenarios  
—Carrie Mears (IA), Eric Kolchinsky (NAIC)
7. Any other matters

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/00 - Agenda/VOSTF Agenda 2022-06-09 v2.docx>



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## MEMORANDUM

TO: Interested Parties of the Financial Condition (E) Committee  
FROM: Financial Condition (E) Committee  
DATE: May 23, 2022  
RE: Memorandum of Support

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Since the great financial crisis, interest rates have generally been in a downward trend for nearly 15 years, resulting in reduced spreads for life insurers and otherwise putting pressure on many members of the industry that depend upon longer-dated, lower risk debt instruments. In addition, recent inflationary pressures and increasing uncertainty resulting from the Russia/Ukraine crisis are exacerbating other challenges for the industry. Members of the Committee remain particularly concerned that macro-economic trends are likely to continue to drive an increase in asset risk for at least some members of the industry.

This memorandum is being issued by the Committee to express its support for several current, interrelated initiatives focused on asset risk or spread risk within the task forces and working groups of the Committee as well as other related work within the task forces and working groups of other Committees, including the Life Insurance and Annuities (A) Committee. The Committee recognizes the range of risk management practices within the industry and the critical importance of maintaining a fair and competitive marketplace by establishing standards if necessary to address issues that could translate into material risks if not properly and timely considered within the NAIC solvency framework.

Although the Committee has not yet reviewed specific proposals from these various groups, it is aware of the underlying objectives of many of the proposals under discussion, including, without limitation:

- A more risk-sensitive Life Risk Based Capital (RBC) charge for certain structured securities and other asset-backed securities that carry a greater tail risk;
- Clarification of investments permitted to be reported on Schedule D-1: Long-Term Bonds, particularly focused on improved transparent accounting and RBC reporting for certain loan-backed and structured securities to capture the more risk-sensitive features of these types of assets;
- Consideration of changes to the current policies of the Valuation of Securities (E) Task Force as they pertain to possible use of or reduction of reliance on rating agencies, where deemed appropriate, and possible use of other risk identifiers such as market data;
- A modified economic scenario generator that more appropriately captures the low interest rates experienced during the past few years; and
- Consideration of certain “high-yielding” assets within the annual asset adequacy analysis testing.

The Committee is grateful to all the States and staff members that are currently participating in the important work of these groups and welcomes the input of industry and other stakeholders in the development of proposals. Although this work is ongoing, the Committee encourages all States and the Securities Valuation Office (SVO) to continue to take all appropriate actions under existing rules and standards.

[https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/01 - Memo from E Committee/2022-005.01 May 23 Letter From E Committee \(002\).docx](https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/01 - Memo from E Committee/2022-005.01 May 23 Letter From E Committee (002).docx)



TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force  
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)  
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Additional Market Data Fields for Bond Investments

DATE: February 25, 2022

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The SVO proposes adding additional market-data fields for bond investments to the annual statement instructions based on 2010 adopted recommendations of the Rating Agency (E) Working Group (RAWG) and the IAO staff's findings regarding the discrepancies between ratings, presented in its Nov. 2021 memo.

The RAWG was formed after the Financial Crisis of 2008 and was charged with gathering and assessing information on:

1. *The problems inherent in reliance on ratings, including impact on the filing exempt ("FE") process and Risk-Based Capital ("RBC");*
2. *The reasons for recent rating shortcomings, including but not limited to structured security and municipal ratings;*
3. *The current and potential future impact of ratings on state insurance financial solvency regulation; and*
4. *The effect of the use of NRSRO ratings on public confidence and public perception of regulatory oversight of the quality of insurance.*

The RAWG made the following summary recommendations in their Apr. 28, 2010, report that was adopted by the Financial Condition (E) Committee (emphasis added):

1. **Regulators explore how reliance on ARO (Approved Ratings Organization) ratings can be reduced when evaluating new, structured, or alternative asset classes, particularly by introducing additional or alternative ways to measure risk;**
2. **Consider alternatives for regulators' assessment of insurers' investment risk, including expanding the role of the NAIC Securities Valuation Office ("SVO"); and**

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3. *When considering continuing the use of ratings in insurance regulation, the **steps taken by the NRSROs in correcting the causes that led to recent rating shortfalls**, including the NRSROs' efforts in implementing the recommended structural reforms, should be taken into account.*

As the IAO staff demonstrated with the analysis in its Nov. 29, 2021, memo regarding ratings discrepancies, not all credit rating provider (CRP) ratings reflect a reasonable assessment of a security's risk, indicating that rating shortfalls persist today. The NAIC has not made additional progress in reducing reliance on CRPs and the IAO proposed several steps in its memo to accomplish that objective. As noted by the RAWG and reflected in the IAO's memo, there persists a situation where "... ratings are neither consistent nor uniform for individual securities, nor across different types and classes of securities..." However, the role of the SVO has not been expanded to include "... evaluating credit and other risks of securities."<sup>1</sup>

One step towards introducing alternative ways to measure a security's risk would be to require insurers to report various analytical measures about each security including metrics such as its current market yield, interest rate sensitivity, spread relative to risk-free securities such as United States Treasuries and average remaining life. The more a security's market yield and spread differ from similarly rated securities, the more likely it is that the implied market-perceived risk of that security differs from the risk indicated by the credit rating assigned to it. The yield difference or spread in basis points can potentially help identify securities whose risk assessment warrants further review by the SVO, examiners or other regulatory groups, for example, a AAA rated security with a yield of 5%. Other fields that measure a security's price sensitivity to interest rate movements may also help to identify market-perceived risk inconsistent with the assigned credit rating. These additional market data fields would align with the RAWG's referral to the Task Force and SVO Initiatives (EX) Working Group, as noted in their following detailed recommendations (emphasis added):

1. *Referral to the NAIC Valuation of Securities (E) Task Force: VOS should continue to **develop independent analytical processes to assess investment risks**. These mechanisms can be tailored to address unique regulatory concerns and should be developed for **use either as supplements or alternatives to ratings**, depending on the specific regulatory process under consideration.*
2. *Referral to the NAIC Valuation of Securities (E) Task Force: ARO ratings have a role in regulation; however, since **ratings cannot be used to measure all the risks that a single investment or a mix of investments may represent in an insurer's portfolio**, NAIC policy on the use of ARO ratings should be **highly selective and incorporate both supplemental and alternative risk assessment benchmarks**.*
3. *Referral to the NAIC's SVO Initiatives (EX) Working Group: NAIC should evaluate whether to **expand the use of SVO and increase regulator reliance on the SVO for evaluating credit and other risks of securities**.*

**Recommendation:** The SVO recommends the following market data fields and related descriptions be added to all the annual statement instructions, through a referral to the Blanks (E) Working Group, for all bonds reported on Schedule D, Part 1 (those within scope of SSAP No. 26R – Bonds and SSAP No. 43R – Loan-Backed and Structured Securities). To allow sufficient time for insurers to update their systems, the SVO further recommends that the changes be implemented as electronic only fields effective beginning with the reporting year ending December 31, 2023.

- Market Yield – The Market Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis. Therefore, Fair

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<sup>1</sup> Evaluating the Risks Associated with NAIC Reliance on NRSRO Credit Ratings – Final Report of the RAWG to the Financial Conditions (E) Committee, April 28, 2010

Value, which is already reported, is the present value (PV) of all expected cash flows discounted at the Market Yield.

- Market Price – The Market Price per unit of Par Value, which is already reported, is reflected in the Fair Value as of the financial statement date. The Market Price, which excludes accrued interest, when multiplied by Par Value and divided by 100 will be equal to the Fair Value.
- Purchase Yield – The Purchase Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis as of the Acquired Date. Therefore, Actual Cost is the present value (PV) of all expected cash flows discounted at the Purchase Yield as of the Acquired Date.
- Weighted Average Life – The Weighted Average Life is the average length of time that each dollar of unpaid principal remains outstanding. The time weightings used in weighted average life calculations are based on payments to the principal. The calculation is "weighted" because it considers when the payments to the principal are made—if, for example, nearly all of the principal payments are made in five years, WAL will be close to five years. Weighted average life does not consider payments to interest on the loan. This value is recalculated at each statement date for the remaining principal payments.
- Spread to Average Life UST - The spread is the difference between the interpolated U.S. Treasury bond yield that matches the reported debt security's Weighted Average Life. Spreads between interpolated U.S. Treasuries and other bond issuances are measured in basis points, with a 1% difference in yield equal to a spread of 100 basis points.
- Option Adjusted Spread - The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return (typically U.S. Treasury yield), which is then adjusted to take into account an embedded option and expressed in basis points. The spread is added to the fixed-income security price to make the risk-free bond price the same as the bond. The option-adjusted spread considers historical data such as the variability of interest rates and prepayment rates. These calculations are complex since they attempt to model future changes in interest rates, prepayment behavior of mortgage borrowers, and the probability of early redemption.
- Effective Duration - This is a duration calculation for bonds that have embedded options. This measure of duration takes into account the fact that expected cash flows will fluctuate as interest rates change and is, therefore, a measure of risk given the security's Fair Value. As a formula, Effective Duration =  $(P(1) - P(2)) / (2 \times P(0) \times Y)$ , where  $P(0)$  = the bond's Market Price per \$100 worth of par value,  $P(1)$  = the price of the bond if the yield were to decrease by Y percent,  $P(2)$  = the price of the bond if the yield were to increase by Y percent, and Y = the estimated change in yield used to calculate  $P(1)$  and  $P(2)$ .
- Convexity - This is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. Convexity demonstrates how the duration of a bond changes as the interest rate changes.
- VISION ISSUE ID: The NAIC VISION system security ID reported in AVS+.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/02 - Blanks Referral Analytical Risk Measures/2021-053.01 Blanks Market Data Disclosure v2.docx>



**Mike Monahan**  
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May 20, 2022

Ms. Carrie Mears, Chair  
Valuation of Securities Task Force  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

**Re: A Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments – Comments Due May 20, 2022**

Dear Ms. Mears,

The undersigned (ACLI, APCIA, PPIA, NASVA) appreciate the opportunity to comment on the exposure entitled “Additional Market Data Fields for Bond Investments” that was released for comment by the NAIC Valuation of Securities Task Force (VOSTF).

The undersigned note that the memorandum from the Securities Valuation Office (SVO) does not fully discuss or specify how the SVO, VOSTF and/or other regulators who would receive the analytic

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American Council of Life Insurers | 101 Constitution Ave, NW, Suite 700 | Washington, DC 20001-2133

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The American Council of Life Insurers (ACLI) is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. 90 million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

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**APCIA** is the primary national trade association for home, auto, and business insurers. APCIA promotes and protects the viability of private competition for the benefit of consumers and insurers, with a legacy dating back 150 years. APCIA members represent all sizes, structures, and regions—protecting families, communities, and businesses in the U.S. and across the globe.

**PPIA** is a business association of insurance companies, other institutional investors, and affiliates thereof, that are active investors in the primary market for privately placed debt instruments. The association exists to provide a discussion forum for private debt investors; to facilitate the development of industry best practices; to promote interest in the primary market for privately placed debt instruments; and to increase accessibility to capital for issuers of privately placed debt instruments. The PPIA serves 63 member companies and works with regulators, NASVA, the American College of Investors Counsel, and the investment banking community to efficiently implement changes within the private placement marketplace.

**NASVA** is an association of insurance company representatives who interact with the NAIC Securities Valuation Office (“SVO”) to provide important input, and to exchange information, in order to improve the interaction between the SVO and its users. In the past, NASVA committees have worked on issues such as improving filing procedures, suggesting enhancements to the NAIC's ISIS electronic security filing system, and commenting on year-end processes.

data included in the proposal would utilize that information and why it is of value to them. This is especially important given the costs associated with compliance by the industry.

The undersigned understand that one of the reasons for requesting this analytic data is to compare market yields for securities with rating agency (CRP) ratings, in order to identify outlier ratings (of 2x plus variances) where the market (through demanding higher yields) ascribes more risk to a particular security than the CRP rating would imply (e.g., the excess spread above the “risk free”, or US Treasury rate, exceeds the expectation for the security’s inherent credit risk, and if applicable, for illiquidity and/or complexity premium).

The undersigned also understand this is especially desired for privately offered structured securities – e.g., as noted under item 10 of the Summary of Referrals from Macroprudential Working Group “Regulatory Considerations Related to but not exclusive to PE” exposure, with comments due June 13, 2022, as well as from comments from various NAIC staff and regulators.

Given the costs associated with this request, the undersigned would appreciate further dialogue on how the data will be utilized and the tangible benefits to regulators. This discussion would allow the benefits to be weighed against the substantial costs associated with providing the data, i.e., compliance with the proposal.

For public securities much, if not all, of this data is already available from other commercially available sources (e.g., Bloomberg, Clearwater, Aladdin, etc.) and it may be more feasible for the SVO to aggregate this data, rather than have each individual insurance company incur the costs to implement systems changes and provide the data. This is especially true when considering that much of the requested data is based on somewhat complex modeling and outputs are heavily dependent upon inputs, which by their nature require significant judgment and therefore will vary by company.

For private securities, the SVO has (or will have) meaningful data from Private Rating Rationale Reports which are likely meant to help address rating agency disparity concerns.

Our comments below are organized into two different sections – 1) Utility of the Data for Regulators and 2) Compliance Costs for Industry. The undersigned’s desire is to help address valid regulator concerns in the most cost beneficial way.

### **Utility of the Data for Regulators**

This section of our letter will address each requested piece of data individually.

Market Yield – The Market Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis. Therefore, Fair Value, which is already reported, is the present value (PV) of all expected cash flows at the Market Yield.

We would not expect this data to be very useful or insightful for the vast majority of securities that will be reported as Issuer Credit Obligations under the new Statutory Accounting Principles Working Group (SAPWG) Proposed Bond Definition (e.g., US Treasuries, US Government Agency, Municipal Bonds, Public Corporate Bonds or Private Corporate Bonds that are designated by the SVO and issued from operating entities). Further, for publicly rated securities, the NAIC has access to analytic data through public information sources, such as Bloomberg.



In addition, the vast majority (~75%) of what will be reported as asset-backed securities (ABS) under the new SAPWG Proposed Bond Definition (e.g., CMBS, RMBS, and potentially CLOs) are, or potentially will be, modeled by the SVO and provided an SVO designation with no weight given to CRP ratings.

For much of the remaining securities, both private credit issuer obligations and private ABS, with a private letter rating, pricing is frequently done via “matrix pricing”. While there is a variety of different methodologies utilized, this pricing methodology often uses some type of yield attributed to internal designations (e.g., use of a CRP rating, and related public index-derived yield, or an internal rating, with a similar index-derived yield). Some companies, in whole or in part, also utilize broker provided spreads or quotes for determining market values. At a minimum, there will be meaningful inconsistencies in the data supplied, as each insurer may bring different methodologies to bear in the market valuation process.

Worse, the data could be of dubious usefulness. For example, if a company internally rates a security as a BBB (based on an external CRP’s BBB rating) and uses a BBB index bond yield to determine fair value, the market yield reflected will closely approximate average BBB yields for public bonds and will not signal whether a security is more or less risky than a typical BBB bond. Said differently, because CRP ratings are a critical variable in determining matrix-based market pricing, it would be a circular process to then use a matrix pricing-derived market yield to identify CRP rating outliers.

The undersigned therefore question the utility of this data to the SVO and regulators.

Market Price – The Market Price per unit of Par Value, which is already reported, is reflected in the Fair Value as of the financial statement date. The Market Price, which excludes accrued interest, multiplied by Par Value and divided by 100 will be equal to the Fair Value.

This information is already currently reported in column 8 of Schedule D. The electronic only columns further identify the source of the market price and the fair value level attributed to it. It is unclear if the SVO is looking for something more on this item.

Purchase Yield – The Purchase Yield is the internal rate of return discount rate that makes the net present value (NPV) of all expected cash flows equal to zero in a discounted cash flow analysis as of the Acquired Date. Therefore, Actual Cost is the present value of all expected cash flows discounted at the Purchase Yield as of the Acquired Date.

The undersigned note that the Effective Rate of Interest is already included on Schedule D (Column 17) and defined in the reporting instructions as follows:

*For issuer obligations, include the effective rate at which the purchase was made. For mortgage-backed/loan-backed and structured securities, report the effective yield used to value the security at the reporting date. The Effective Yield calculation should be modified for other-than-temporary impairments recognized.*

The undersigned note that both of these definitions essentially equate book value to the future expected cash flows, which is the same as  $NPV = 0$ . Therefore, it makes sense to align these definitions to ensure the information being utilized by regulators is being efficiently obtained. Further, book yield is an objective yield that may be more beneficial for the stated intent (i.e., yield disparity for an initial CRP rating).

The utility of purchase yield for purposes of identifying excess spread, is the most relevant as it compares the excess spread, to a CRP rating when the deal is committed to. Purchase yield is a fact. For private securities, all valuations assigned subsequent to time of commitment are educated estimates. These estimates may vary for any number of reasons, beyond just the CRP rating including: short-term market movements, impairments, changing circumstances with respect to specific companies or industries, delay in rating agency downgrades, etc. For outliers, the SVO can certainly dig deeper to identify the root causes – e.g., for private securities, note purchase agreements, rating rationale reports, copies of the notes, etc. which the SVO should already have; for public securities, Bloomberg or SEC websites are readily available. In short, in attempting to identify 2x plus variances, the spread over the US Treasury rate (utilizing purchase yield at the time of commitment is going to be the most significant indicator of an outlier CRP rating. The remaining data has very limited additional value in identifying such outliers – e.g., duration matters but is less impactful as it pertains to identifying 2x variances.

Weighted Average Life (WAL) – The Weighted Average Life is the average length of time that each dollar of unpaid principal remains outstanding. The time weightings used in weighted average life calculations are based on payments to the principal. The calculation is "weighted" because it considers when the payments to the principal are made—if, for example, nearly all the principal payments are made in five years, WAL will be close to five years. Weighted average life does not consider payments to interest on the loan. This value is recalculated at each statement date for the remaining principal payments.

WAL can be thought about as a way of estimating the tenor of an investment and is often considered in establishing the interest rate. On a stand-alone basis, the undersigned do not understand why the WAL is particularly useful as other factors related to each investment are considered. The value of WAL as a measure may be diminished when there is potential variability in cash flows due to embedded options or in asset-backed securities. This potential for cash flow variability also increases the likelihood that the WAL measure will vary by company. Therefore, focusing on spread over the US Treasury rate (utilizing purchase yield) should be sufficient to identify outliers. See our discussion on duration below.

Spread to Average Life UST (UST Spread) - The spread is the difference between the interpolated U.S. Treasury bond yield that matches the reported debt security's Weighted Average Life. Spreads between interpolated U.S. Treasuries and other bond issuances are measured in basis points, with a 1% difference in yield equal to a spread of 100 basis points.

Option Adjusted Spread (OAS) - The option-adjusted spread is the measurement of the spread of a fixed income security rate and the risk-free rate of return (typically U.S. Treasury yield), which is then adjusted to take into account an embedded option and expressed in basis points. The spread is added to the fixed income security price to make the risk-free bond price the same as the bond. The option-adjusted spread considers historical data such as the variability of interest rates and prepayment rates. These calculations are complex since they attempt to model future changes in interest rates, prepayment behavior of mortgage borrowers, and the probability of early redemption.

Both the UST Spread and OAS are certainly different ways to calculate the spread over the US Treasury rate, just as with using purchase yield and market yield.

For securities without embedded prepayment or extension risk, we believe spread at time of commitment (e.g., utilizing the purchase yield) will be the most relevant metric and will be most meaningful to the SVO and regulators.

For securities with embedded prepayment or extension risk, while OAS could provide some incremental additional insight, it also has some additional drawbacks. Calculating the OAS involves projecting many future interest-rate scenarios and their probabilities, as well as assumed borrower behavior. To the extent that each insurer has its own proprietary optionality model, OAS for the same security will differ insurer to insurer.

In any case, these are just other forms of spread over treasury which the undersigned believe are unnecessary when trying to identify 2x plus variances, especially considering the costs for each company to comply, and their reliability due to subjective inputs in a complex calculation. Therefore, focusing on spread over the US Treasury rate at time of commitment (utilizing purchase yield) should be sufficient to identify outliers.

Lastly, there is concern among industry that this data would be inconsistent with other data utilized by insurance companies (e.g., the NAIC Valuation Manual for Life and Annuity Reserves requires the use of spreads in very prescriptive form).

Effective Duration - This is a duration calculation for bonds that have embedded options. This measure of duration takes into account the fact that expected cash flows will fluctuate as interest rates change and is, therefore, a measure of risk given the security's Fair Value. As a formula, Effective Duration =  $(P(1) - P(2)) / (2 \times P(0) \times Y)$ , where P(0) = the bond's Market Price per \$100 worth of par value, P(1) = the price of the bond if the yield were to decrease by Y percent, P(2) = the price of the bond if the yield were to increase by Y percent, and Y = the estimated change in yield used to calculate P(1) and P(2).

Convexity - This is a measure of the curvature, or the degree of the curve, in the relationship between bond prices and bond yields. Convexity demonstrates how the duration of a bond changes as the interest rate changes.

Both Effective Duration and Convexity are interest rate risk measures and are not indicators of credit risk. While such measures are certainly useful for a life insurance company, it is primarily in the context of comparing the duration and convexity of their asset portfolios to the duration and convexity of their liabilities. These data are most useful in estimating prices given changes in interest rates, while the price drivers are based on an investor's view of cash flows, including any embedded options. Because of this, we question their ability to explain a 2x variance in the purchase yield. Additionally, these calculations require very challenging assumptions on volatility which would certainly lead to different outcomes for different companies. Thus, in the context of the varying assumptions on the inputs, and the limited value in identifying 2x variances, the undersigned do not believe there is sufficient value in pursuing the creation of these fields.

VISION ISSUE ID - The NAIC VISION system security ID reported in AVS+.

The undersigned are not aware of any instance in which the VISION ISSUE ID is currently captured by industry, nor included on any reporting schedule. If a company is a filer of a particular security, they typically do not save the VISION ISSUE ID, and if they are not the filer, they would have no reason to seek and retain it.

Due to these factors and our limited understanding of the technical architecture of the NAIC VISION system, the undersigned wonder whether the SVO could utilize the identifiers (e.g., CUSIP) for each investment on Schedule D to cross-reference the VISION ISSUE ID.

## Compliance Costs for Industry

The effort and cost of supplying this data is significant. We see the effort broken into two challenges: data capture and creation of the electronic Schedule D:

The data capture challenge fits into one of the following scenarios:

- The data in whole or in part is not utilized by some companies for a variety of reasons, including because some companies do not manage their investment portfolio internally,
- The data is utilized by companies on an ad hoc basis and is not saved or stored, or
- If the data is saved or stored, it is done so on a de-centralized basis and not maintained in the companies' reporting systems.

Capturing the data is only one of the challenges. In order to deliver the requested data fields, the data would need to be included in the electronic Schedule D that is included in a Company's Annual Statement software package. There are several vendors that provide annual statement packages, and they work similarly. Each schedule is loaded to the package as a flat file in the specified format. Flat files are a collection of records in which the data follows a uniform format and follows rules on value types where applicable. The database is flat because every line only holds one data input, depending on the categorization of the columns within the file. The software packages can't take feeds from multiple sources to prepare the schedule. The annual statement software providers likely won't change their requirements to facilitate creation of the schedule that includes these fields so it would be up to companies to create the reporting in the required flat file.

Today, the Schedule D flat files are generated by the investment accounting system used by the company. There are several of these systems in the market. Most, if not all, of these systems do not contain information or programming to calculate the requested fields. Nor do they have a place to store the data with programming to reference such stored fields to facilitate the requested reporting. To do this would be a significant, and likely expensive, development project.

Because of these circumstances, the creation of the requested electronic Schedule D would require a manual process that combines information from multiple data sources. Beyond the cost of creating this manual process and previously stated concerns about data availability, implementing this process in a controlled manner that is required for all financial reporting would require development and testing, which would take considerable time, in addition to the implementation and ongoing cost, given the complexity. Coupled with the other significant NAIC activities, the resources to implement this broad and extensive proposal are very challenging even with a proposed year-end 2023 effective date.

These data capture and schedule creation scenarios present varying degrees of significant challenges in providing the requested information on potentially thousands or tens of thousands of securities for a single company. Each would require companies to develop and maintain processes and internal controls over centralized data capture and financial reporting protocols for data elements which currently don't exist.

## Conclusion

Given the concerns expressed above; the data may be available from other sources, the potential lack of utility of the requested data, and the costs and efforts to comply, the undersigned would like to work with regulators to get a better understanding of the actual need for this data, as well as how

the SVO expects to use the data. This would allow us to provide more constructive feedback on this proposal so it can be implemented in the most cost-efficient manner. Due to the significant effort and cost associated with complying with this proposal, for each and every insurance company, it should be evaluated against the actual benefits that will accrue to regulators, especially in the context of other SVO/VOSTF initiatives. The undersigned believe it would be unwise to hastily implement this proposal “as is” only to acknowledge later that the utility of this data is of limited value. Furthermore, we would like to explore whether it is more cost efficient for such data, or a subset of such data, to be centrally aggregated by the SVO for their use in analysis, rather than by insurers individually.

Thank you for considering the undersigned comments. If you have any questions in the interim, please do not hesitate to contact us.

Sincerely,



Mike Monahan  
Senior Director, Accounting Policy

*Tracey Lindsey*

Tracey Lindsey  
NASVA

*John Petchler*

John Petchler  
on behalf of PPIA  
Board of Directors



Stephen W. Broadie  
Vice President, Financial & Counsel

Cc: NAIC Staff  
Interested Parties

The Lease-backed Securities Working Group

May 19, 2022

Ms. Carrie Mears, Chair  
Valuation of Securities Task Force  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

RE: A Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments – Comments Due May 20, 2022

Dear Ms. Mears

This letter is in response to the recent SVO recommendation for a number of additional market data fields to be supplied by insurers for all bond investments. We understand that the additional data, all of which relates to the pricing of securities, would be used by the SVO to “screen” securities and identify outliers “whose [NRSRO] risk assessment warrants further review by the SVO” with the ultimate goal of assessing the reliability of NRSRO ratings. While the memo does not lay out in detail how this screening process would be implemented, we would like to point out several factors for regulators to consider:

To begin with, we are sure that regulators understand that credit is not the sole determinant of price (or yield) for any security. Many factors which are not credit-related influence the pricing of security. In addition to deal-specific factors such as callability or extension risk, which may or may not be factored into a credit rating, these can include regulatory risk, market timing, frequency -- or scarcity -- of offerings for a particular type of investment, investor appetite -- or capacity limits -- for specific credits, etc. Any screening process to identify securities for further credit review based primarily on pricing averages must also take these factors into account.

While in the public bond markets it is broadly true that credit and price -- risk and reward -- are correlated, this relationship is much weaker in the private markets. For public bonds, it is the “market” which determines at what price (or yield) any given investment will ‘clear’ the market. For this reason, in the public market individual investors -- including insurance companies -- are all “price-takers”: the only decision being whether or not to participate in an investment at the given market yield.

In the private market individual investors are frequently able to exert a considerable influence on pricing. This is particularly true on smaller “bespoke” deals tailored to meet the investment needs of a small group of investors, and where transaction terms, including pricing, are much more highly-negotiated than is possible with public offerings. For this reason, the variability of pricing is much larger in the private market than it is for public debt.

In fact, the private markets, and particularly these smaller niche investments, are one of the few places insurance companies are occasionally able to find “value” in the market: that is, being well-compensated relative to the estimated risk of a given transaction (many of us would say “adequately compensated” relative to public markets). This is one of the main reasons insurance companies participate in private debt transactions to begin with. It would be a shame if any screening process resulted in insurance companies being penalized for their ability to occasionally find “value” in the private markets.

## The Lease-backed Securities Working Group

Secondly, even looking at broad market averages, there is no fixed correlation between public and private bond spreads over time. The relationship between the two markets fluctuates widely and is influenced by many factors. Since the only available data set is a historical one for public bond ratings and spreads, any extrapolation of these into the private bond market at different points in time is bound to be a very imperfect exercise.

Even if there were a fixed relationship between the two markets, as mentioned above, the variability in pricing *within* the private market at any given credit rating is much greater than for public bonds -- a measure of the relative "inefficiencies" that can still occasionally be found in the private markets. The use of average historical public bond spreads as a screen for an appropriate private bond credit rating could lead to many "false positives", and needs to be supplemented by rigorous analysis of the specific transaction and a detailed critique of the NRSRO's own rating analysis.

For these reasons we believe that any use of market yields -- particularly broad historical indexes of public market average yields or spreads applied to private bonds -- must take all these factors into account.

Finally, as long as Filing Exemption remains in place, any designation by the SVO which would override the rating of a nationally-recognized ratings provider should be the result of a transparent methodology and ratings report by the SVO supplied to the investor -- similar to those supplied by the nationally-recognized providers -- and also subject to appeal by the holder of security.

We appreciate the opportunity to offer these comments and are happy to discuss this letter and any questions you might have with the members of the Task Force.

Sincerely,

John Garrison

*On behalf of:* The Lease-Backed Securities Working Group.



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May 20, 2022

Ms. Carrie Mears, Chair  
Valuation of Securities Task Force  
National Association of Insurance Commissioners  
1100 Walnut Street, Suite 1500  
Kansas City, MO 64106-2197

*Re: Proposed Referral to the Blanks (E) Working Group to Add Fixed Income Analytical Measures to Investments Reported on Schedule D, Part One – Additional Market Data Fields for Bond Investments*

Dear Ms. Mears and Task Force Members,

As an independent consultant and long-time observer of the work of the Valuation of Securities Task Force I appreciate the opportunity to comment on the captioned proposal in writing, as I did orally at the most recent NAIC Spring National Meeting.

The proposal is to require insurers to provide additional data concerning their holdings of bonds. Before this proposal is advanced it is important to specify what needs this data can fulfill in order to determine what characteristics may be needed. It is also essential to develop and test the methods, techniques and tools that will use these characteristics to answer the questions that regulators will have. When it is established which characteristics can be used effectively, then it will be appropriate to require their submission.

### **Objectives**

It seems there are two distinct questions insurance regulators might have concerning the investments of insurers in bonds. These are:

- **Question One: To what extent should the credit opinions of the Nationally Recognized Statistical Rating Organizations be relied upon? and,**
- **Question Two: How can insurance regulators, in all of their capacities, better understand the investment risks being assumed by the insurers they regulate?**

A key point here is that these two questions, while seeming quite similar, are actually very different indeed and will require different approaches.



**Credit Risk**<sup>1</sup> is at the heart of **question one** because credit risk is the single risk element measured by NRSRO ratings. Achieving the desired level of accuracy for these risk opinions is important because they are the source of the vast majority of NAIC Designations that are translated into RBC credit risk factors C1 and R1.

**Investment Risk** needs to be understood to answer **question two** because it is a broader measure of risk which includes not only credit risk but the broadest range of risks to which an insurer is exposed.

### **The Differences Between Credit Risk and Investment Risk**

**Credit risk** is simply one specific type of the broader category of investment risks. Credit risk is the sole risk reflected in the C1 and R1 factors for RBC and, in fact, these factors were explicitly designed to measure this one risk element in the RBC calculation. C1 and R1 factors were developed using the credit risk metrics and experience of the NRSROs and recently when they were updated the same credit standards were used. Attempting to add non-credit elements to NAIC Designations may be tempting but that would compromise the integrity of the RBC calculation as NAIC Designations are translated directly into C1 and R1 credit risk factors based on NRSRO data.

**Investment risk** is the broadest measure of risk of investing in bonds and it includes credit risk. Regulators have been familiar with this distinction for many years and in fact completed a study of risks<sup>2</sup> and found that these, in addition to credit, are risks inherent in bonds: Event, Liquidity, Call/Extension, Deferral, Currency and Leverage, and there are many others that affect yields and, hence, spreads.

### **Question One: Is Reliance on NRSROs Well-Founded?**

The NAIC relies heavily on the nine NRSROs for their bond credit ratings which insurers can use to determine the C1 and R1 factors for Risk Based Capital calculations. This is reasonable because together these NRSROs have thousands of analysts, well-developed public methodologies, robust infrastructures and many other strengths. The essential question insurance regulators need to ask, however, is whether the credit ratings they produce are of sufficient accuracy to be used for C1 and R1 RBC factors so as to assure that the overall RBC calculations are of reasonable accuracy.

**Unfortunately measures of spread, however calculated, will measure investment risk and not credit risk so spread metrics cannot be used simply, if at all, to determine the reliability of NRSRO ratings.** This may be inconvenient, but it is a reality. This is not to say that this cannot be done, but without the development of complicated and sophisticated tools to distinguish credit risk from the wide range of other factors that affect spreads this would be quite difficult indeed. It should be noted that this has also eluded many in the past.

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<sup>1</sup> Credit risk is commonly defined as the possibility of a loss to a lender resulting from a borrower's failure to repay a loan or meet contractual obligations.

<sup>2</sup> Report of the Risk Subgroup of the IAWG (then an entity of the VOSTF), Attachment Two-A9, VOSTF, 12/06/08. Available upon request.

Other techniques can be used -- but they, too, are not simple. One source of data that is intended to indicate the durability of the ratings over time of NRSROs is, of course, Exhibit 1, “Performance

Measurement Statistics” of Form NRSRO which the Securities and Exchange Commission requires and examines annually for all NRSROs. Another resource is the SEC’s Annual Report on NRSROs<sup>3</sup> but among its limitations is that it is not specific as to the identities of the individual NRSROs. The methodologies that SEC requires the NRSROs it regulates to publish could be evaluated for their comprehensiveness. This has greater potential than it might otherwise seem because the SEC itself monitors compliance of each NRSRO with its methodologies even as it does not disclose its findings on an individual basis.

In summary, assessing reliability of NRSRO rating opinions is not an easy task

## **Question Two**

On a macro level various spread metrics can indicate overall level of investment risk but it is very challenging to disaggregate these risks on any scale even though many have attempted to do this.

In addition to the six other-than-credit risks listed above I am sure other commentators will describe many more investment risk elements that result in higher spreads. Complexity is one example. It is difficult to analyze complex securities and insurers that do this difficult work expect to receive compensation in the form of higher yields. Another is innovation. As with complexity, it takes significant resources to evaluate new structures in order to fully understand their risks. Investors expect to be rewarded for their work on this as well and issuers are willing to oblige with higher yields. These are just two examples and it should also be remembered that due to differing liability structures the same characteristic that might increase risk to one insurer might actually dampen risk to another.

An obvious point is how difficult it can be, given a specific bond, to determine if a given insurer has adequately assessed and evaluated the totality of the risks it undertakes. While spread metrics can indicate the presence of risk in aggregate it would take considerable effort to attribute spread differentials to their various underlying sources in order to make them visible. In other words, it is possible to see that risk exists, and an analysis of spreads may facilitate that, but it is exceedingly difficult to determine the exact sources of the risk in order to ascertain whether a given insurer is managing that risk prudently.

## **It is Possible to Begin Developing Screening Tools Now**

Even though the prospects may seem limited, the NAIC could begin working now on developing screening tools. This could be done using existing data available for public securities. The use of public data should not compromise the results given that the SEC mandates that all NRSROs apply exactly the same rating standards to public and private securities and the SEC monitors compliance. Consequently, the lessons learned from beginning work now could potentially point

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<sup>3</sup> SEC Office of Credit Ratings “Annual Report on NRSROs as Required by Section 6 of the Credit Rating Agency Reform Act of 2006”

the direction to developing useful screening tools to answer both questions or, at worst, demonstrate the difficulty of producing effective tools.

page four

Anderson Insights to the Valuation of Securities Task Force

May 20, 2022

### **Meeting the Needs of Regulators**

Even the most carefully thought-out solutions can benefit from input from the parties they are intended to benefit. It is quite possible that a broad range of regulators could find productive uses for additional data. It would be beneficial, then, to seek out potential users and involve them in all stages of the development process from goal-setting through prototype development and even follow ups once they have been using the tools that are developed. It should be noted that sometimes users can make their most useful contributions once they have seen something tangible such as a prototype or well-developed design.

### **Summary**

The two very relevant and important questions of the appropriate extent of reliance on the credit ratings of bonds by NRSROs and how insurance regulators can improve their abilities to identify and assess investment risk are related but separate. One involves pure credit risk whereas the other represents the totality of investment risk. Accordingly, it is likely that more sophisticated tools, rather than simply reviewing various spreads, will be required to achieve improved capabilities.

### **Conclusion**

It seems wise, at the very least, to have tested screening mechanisms in place or at least in the final stages of development prior to requiring insurers to produce more data. It would be very unfortunate to implement data requirements, wait months or years for compliance and then discover that the data or system are insufficient to meet objectives. Even as exploratory work could begin now with existing data, enthusiasm for this needs to be tempered by the realities of how difficult it would be to untangle the web of risks in fixed-income investments either to assess the efficacy and reliability of NRSRO ratings or to better understand the individual risks being undertaken by insurance companies.

Hopefully there are reasonable and practical approaches to improve the answers to the two important questions being discussed but it is not at all likely they will be simple. As H.L. Menken once said, "For every complex problem there is an answer that is clear, simple, and wrong". Even so, work could begin to assess the prospects for success and that could indicate what, if any, additional data will be required of insurers. At the very least it is almost certain that valuable lessons would be learned.

Sincerely,



Copies: Charles Therriault  
Denise Genao-Rosado



TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force  
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)  
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau

RE: Update to the Purposes and Procedures Manual of the NAIC Investment Analysis Office  
clarifying the SVO's role regarding accounting and reporting

DATE: May 23, 2022

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**Summary** - Historically, the SVO has worked with our statutory accounting colleagues to make accounting and reporting determinations which guided whether the SVO could analyze and designate an insurer's investment. The Purposes and Procedures Manual of the Investment Analysis Office (the "P&P Manual"), however, currently provides conflicting guidance on whether the SVO should have a role interpreting accounting and reporting guidance. While many sections of the P&P Manual state that the SVO may assign NAIC Designations to any investment filed with it for which it has a methodology, it also specifies in Part One, Paragraph 40 that the SVO is assigned to assess investments reported on Schedules D and BA and shall communicate to insurers if an investment is not eligible for those schedules and can therefore not be assigned an NAIC Designation.

Part One, Paragraph 32 of the P&P Manual explains that the assessment of an investment's credit risk is distinct from the determination of statutory accounting or reporting under the Accounting Practices & Procedures Manual ("AP&P):

**NAIC Designations Do Not Communicate Statutory Accounting or Reporting** - The assessment of credit risk for an obligation or asset, as specified in the P&P Manual, is a separate and distinct process from the determination of statutory accounting or reporting under the AP&P Manual. The manner in which an NAIC Designation is used within statutory accounting guidance is limited to that, if any, specified in a Statement of Statutory Accounting Principles (SSAP) and cannot be derived or implied by language in the P&P Manual. Obtaining an NAIC Designation does not change an investment's applicable SSAP, annual or quarterly statement reporting schedule, or override other SSAP guidance required for the investment to be an admitted asset. There are limited instances in which a SSAP specifically identifies, within its scope, the inclusion of specific SVO-Identified investments. The SVO review required for an investment to be included on an SVO listing is a separate evaluation process that focuses on the structure of the investment. This process is distinct from the SVO's assessment of an investment's credit risk, which results in a NAIC Designation. As stated in the Statutory Hierarchy, Section V of the Preamble,

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the AP&P Manual is the highest level of authoritative guidance.

Part One, Paragraph 33 of the P&P Manual explains that accounting and reporting determinations for investments are the obligation of the insurance company but that the state regulators remain the final authority:

**Sources and Application of Statutory Accounting Guidance** - The authority to determine and interpret existing statutory accounting guidance in, or to develop new statutory accounting guidance for, the AP&P Manual, is a charge assigned by the Financial Condition (E) Committee through its Accounting Practices and Procedures (E) Task Force to the Statutory Accounting Principles (E) Working Group. The application of statutory accounting guidance to any specific obligation or asset to determine its status under the AP&P Manual is the obligation of the insurance company and its management. The state of domicile is the final authority with respect to statutory accounting and reporting guidance. Deviations from the authoritative guidance in the Statutory Accounting Hierarchy are reflected as a permitted or prescribed practice.

Part One, Paragraph 34 of the P&P Manual expressly states that the SVO can assess any investment filed with it, so long as it has the methodologies to do so:

**Impact on SVO Operations** - Because SVO analytical determinations of credit quality do not convey opinions, conclusions or informational content relative to statutory accounting status, the SVO may assign an NAIC Designation to any obligation or asset that is filed by an insurer, provided that its credit quality can be assessed consistently with the policies and methodologies specified in the P&P Manual.

Part One, Paragraph 40 of the P&P Manual, however, states that the SVO is assigned to assess investments reported on Schedules D and BA and that it may need to communicate to insurers that the investment is not eligible for reporting on Schedules D or BA and, therefore, cannot be assigned an NAIC Designation:

**Authority to Direct Insurers on Reporting** - The SVO is assigned to assess investment securities reported to state regulators on Schedule D and Schedule BA. To fulfill its function SVO must be able to communicate to an insurer that has filed a financial instrument or security that the financial instruments or security is not an investment security eligible for reporting on Schedule D and Schedule BA. SVO may be required to communicate to an insurer that it must refile a financial instrument or security to another schedule. SVO may also have to communicate to an insurer that an instrument the insurer has filed does not meet the definition of an Investment Security in this Manual and is therefore not eligible to be assessed or that the financial transaction or security is a Regulatory Transaction that can only be assessed by the SVO but only in accordance with the procedures discussed in this Manual if requested by a state insurance department. When situations occur that require the SVO to communicate reporting or related statutory guidance to an insurer, SVO consults with Financial Regulatory Services Division staff to ensure the communication to the insurer is accurate.

**Recommendation** – The SVO recommends the below changes to P&P Manual Part One, Paragraph 40 to provide for consistent instruction to the SVO regarding its authority regarding accounting and reporting

guidance. The proposal would clarify, in accordance with Part One, Paragraph 34, that the SVO can assign NAIC Designations to investments which it does not think are eligible for Schedule D or BA reporting so long as it has the methodology to do so. The SVO, however, would have the authority, at its discretion, to notify the appropriate regulators of any investments which, in its opinion, would not or might not be eligible for reporting on Schedules D or BA. The SVO would also maintain its authority to offer its accounting and reporting opinion, when requested to do so, as part of its Regulatory Treatment Analysis Service, it being understood that such opinions would not be authoritative and might not reflect the opinion of the relevant state regulator.

**Proposed Amendment** - The proposed text changes to P&P Manual are shown below with additions in red underline and deletions in ~~red-strikethrough~~, as it would appear in the 2022 P&P Manual format.

**PART ONE**

**POLICIES OF THE NAIC VALUATION OF SECURITIES (E) TASK FORCE**

## **POLICIES PERTAINING TO SVO AND SSG OPERATIONS**

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### **Authority to Direct Insurers on Reporting**

40. The SVO is assigned to assess investment securities reported by insurers to state regulators on Schedule D and Schedule BA. For the avoidance of doubt, the SVO's opinion that an investment is ineligible for reporting on Schedule D or Schedule BA shall not prevent the SVO from assigning an NAIC Designation to that investment. The SVO may, but is not obligated to, notify appropriate state regulators of an insurer's investment which, in its opinion, would not or might not be eligible for reporting on Schedule D or Schedule BA, regardless of the investment's NAIC Designation status. The SVO shall give its statutory accounting and reporting opinion, if requested to do so, as part of its Regulatory Treatment Analysis Service, it being understood that such opinion is not authoritative and may not reflect the opinion of the relevant state regulator. To fulfill its function SVO must be able to communicate to an insurer that has filed a financial instrument or security that the financial instrument or security is not an investment security eligible for reporting on Schedule D and Schedule BA. SVO may be required to communicate to an insurer that it must refile a financial instrument or security to another schedule. SVO may also have to communicate to an insurer that an instrument the insurer has filed does not meet the definition of an Investment Security in this Manual and is therefore not eligible to be assessed or that the financial transaction or security is a Regulatory Transaction that can only be assessed by the SVO but only in accordance with the procedures discussed in this Manual if requested by a state insurance department. When situations occur that require the SVO to communicate reporting or related statutory guidance to an insurer, SVO consults with Financial Regulatory Services Division staff to ensure the communication to the insurer is accurate.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/03 - SVO Role regarding accounting and reporting/2022-002.01 Task Force 2022 Amend SVO Accounting Reporting.docx>





TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force  
Members of the Valuation of Securities (E) Task Force

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau  
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)  
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Part Four Manual Updates

DATE: February 25, 2022

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**Summary:** With the adoption of new Risk Based Capital factors for each NAIC Designation Category in 2021 by the Capital Adequacy (E) Task Force and its parent, the Financial Condition (E) Committee, technical updates are needed in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* (P&P Manual) to reflect a consistent reference to “NAIC Designation Category” and the additional price points needed to determine them.

**Recommendation:** The Securities Valuation Office (SVO) and Structured Securities Group (SSG) staff recommend adoption of these non-substantive technical updates to the P&P Manual that were discussed at the Task Force’s 2021 Summer National Meeting, Sep. 30, and Nov. 17, 2021 interim meetings, and 2022 Spring National Meeting.



**PART FOUR**  
**THE NAIC STRUCTURED SECURITIES GROUP**

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## DEFINITIONS

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- **Price Grids** means and refers to CUSIP-specific price matrices containing ~~six~~ **nineteen** price breakpoints; i.e., each price corresponding to a specific NAIC **Designation and Designation Category**. Each breakpoint on a Price Grid is the price point that tips the NAIC **Designation and Designation Category** for the **RMBS or CMBS** CUSIP into the next NAIC **Designation and Designation Category** (credit quality/credit risk) ~~category~~. The plural is used because two Price Grids are generated for any CUSIP. This reflects the difference in RBC for those insurance companies that maintain an asset valuation reserve and for those insurance companies that do not.

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## ANALYTICAL ASSIGNMENTS

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### Use of Financial Modeling for Year-End Reporting for RMBS and CMBS

22. Beginning with year-end 2009 for RMBS and 2010 for CMBS, probability weighted net present values will be produced under NAIC staff supervision by an NAIC-selected vendor using its financial model with defined analytical inputs selected by the SSG. The vendor will provide the SSG with a Intrinsic Price and/or a range of net present values for each RMBS or CMBS corresponding to each NAIC Designation **and Designation Category**. The NAIC Designation **and Designation Category** for a specific Legacy Security RMBS or CMBS is determined by the insurance company, based on book/adjusted carrying value ranges, and the NAIC Designation **and Designation Category** for a specific non-Legacy Security RMBS or CMBS is determined by the NAIC Designation Intrinsic Price Mapping by SSG.

**NOTE:** Please refer to *SSAP No. 43R—Loan-Backed and Structured Securities* for guidance on all accounting and related reporting issues.

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## Use of Net Present Value and Carrying Value for Financially Modeled Legacy Security RMBS and CMBS

26. For each modeled Legacy Security RMBS and CMBS, the financial model determines the net present value at which the expected loss equals the midpoint between the RBC charges for each NAIC Designation and Designation Category; i.e., each price point, if exceeded, changes the NAIC Designation and Designation Category. Net present value is the net present value of principal losses, discounted using the security's coupon rate (adjusted in case of original issue discount securities to book yield at original issue and in case of floating rate securities, discounted using ~~LIBOR-curve benchmark rate~~ + Origination spread). Because of the difference in RBC charge, the deliverable is ~~five~~ **nineteen** values for each RMBS and CMBS security for companies required to maintain an asset valuation reserve (AVR) and ~~five~~ **nineteen** values for companies not required to maintain an AVR. This is illustrated in the chart below.

NAIC Designation Category	Life		P&C	
	RBC Factor (Pre-Tax)	Midpoint	RBC Factor	Midpoint
1.A	0.158%	0.215%	0.200%	0.300%
1.B	0.271%	0.345%	0.400%	0.500%
1.C	0.419%	0.471%	0.600%	0.700%
1.D	0.523%	0.590%	0.800%	0.900%
1.E	0.657%	0.737%	1.000%	1.150%
1.F	0.816%	0.916%	1.300%	1.400%
1.G	1.016%	1.139%	1.500%	1.650%
2.A	1.261%	1.392%	1.800%	1.950%
2.B	1.523%	1.846%	2.100%	2.300%
2.C	2.168%	2.660%	2.500%	4.000%
3.A	3.151%	3.844%	5.500%	5.750%
3.B	4.537%	5.277%	6.000%	6.300%
3.C	6.017%	6.702%	6.600%	6.850%
4.A	7.386%	8.461%	7.100%	7.400%
4.B	9.535%	10.982%	7.700%	8.200%
4.C	12.428%	14.685%	8.700%	9.250%
5.A	16.942%	20.370%	9.800%	10.350%
5.B	23.798%	26.899%	10.900%	11.450%
5.C	30.000%	30.000%	12.000%	21.000%
6	30.000%		30.000%	

RBC charge / NAIC designation (pre-tax)

P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4		7.25%
5		20.00%
6		
Life		Midpoint
1		0.85%
2		2.95%
3		7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

To Be Deleted

27. The NAIC Designation and NAIC Designation Category for a given modeled Legacy Security RMBS or CMBS CUSIP owned by a given insurance company depends on the insurer’s book/adjusted carrying value of each RMBS or CMBS, whether that carrying value, in accordance with *SSAP No. 43R—Loan-Backed and Structured Securities*, paragraphs 25 through 26a, is the amortized cost or fair value, and where the book/adjusted carrying value matches the price ranges provided in the model output for each NAIC Designation ~~and Designation Category and the mapped NAIC Designation Category, reflected in the table below, to be used for reporting an NAIC Designation Category until new prices ranges are developed to reflect the full range of new Risk-Based Capital factors adopted for each NAIC Designation Category;~~ except that a modeled Legacy Security RMBS or CMBS tranche that has no expected loss under any of the selected modeling scenarios would be assigned an **NAIC 1 Designation** and **NAIC 1.A Designation Category** regardless of the insurer’s book/adjusted carrying value.

NOTE: Please refer to the detailed instructions provided in SSAP No. 43R.

<del>NAIC Designation</del> <del>Determined by</del> <del>Modeled Price Ranges</del>	<del>Mapped NAIC</del> <del>Designation Category</del>
1	1.D
2	2.B
3	3.B
4	4.B
5	5.B
6	6

## **MORTGAGE REFERENCED SECURITIES**

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### **NAIC Risk Assessment**

32. In determining the NAIC Designation **and Designation Category** of a Mortgage Referenced Security, the SSG may use the financial modeling methodology discussed in this Part, adjusted (if and as necessary) to the specific reporting and accounting requirements applicable to Mortgage Referenced Securities.

### **Quarterly Reporting for Mortgage Reference Securities**

33. To determine the NAIC Designation **and Designation Category** to be used for quarterly financial statement reporting for a Mortgage Reference Security purchased subsequent to the annual surveillance described in this Part, the insurer uses the prior year-end modeling data for that CUSIP (which can be obtained from the NAIC) until the annual surveillance data is published for the current year. For a Mortgage Reference Security that is not in the prior year-end modeling data for that CUSIP, the insurer may follow the instructions in Part Two of this manual for the assignment of the SVO Administrative Symbol “Z” provided the insurer owned security meets the criteria for a security that is in transition in reporting or filing status.

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## GROUND LEASE FINANCING TRANSACTIONS

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### SSG Role and Process

35. On occasion, the SVO may refer a GLF transaction to the SVO for financial modeling of the GLF space leases or business operation, as applicable, in accordance with the process set forth in “Ground Lease Financing Transactions” in Part Three of this Manual. Following an SVO referral the SSG and SVO will maintain open communication related to requests for additional data, analytical questions and analytical conclusions. Any GLF transaction NAIC Designation and Designation Category will be assigned by the SVO.

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## THE RTAS – EMERGING INVESTMENT VEHICLE

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### Purpose

36. Price grids and/or NAIC Designation and Designation Categories are generated for the exclusive use of insurance companies and the NAIC regulatory community. Insurance companies use official Prices Grids and/or NAIC Designations and Designation Categories by following the instructions in *SSAP No. 43R—Loan-Backed and Structured Securities* to derive a final NAIC Designation and Designation Category for the RMBS or CMBS, which they use to derive the RBC applicable for the RMBS or CMBS.

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/04 - Part Four Updates/2022-003.01 Part Four Updates v2.docx>



TO: Carrie Mears, Chair, Valuation of Securities (E) Task Force  
Members of the Valuation of Securities (E) Task Force

FROM: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau  
Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)  
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

RE: Risk Assessment of Structured Securities - CLOs

DATE: May 25, 2022

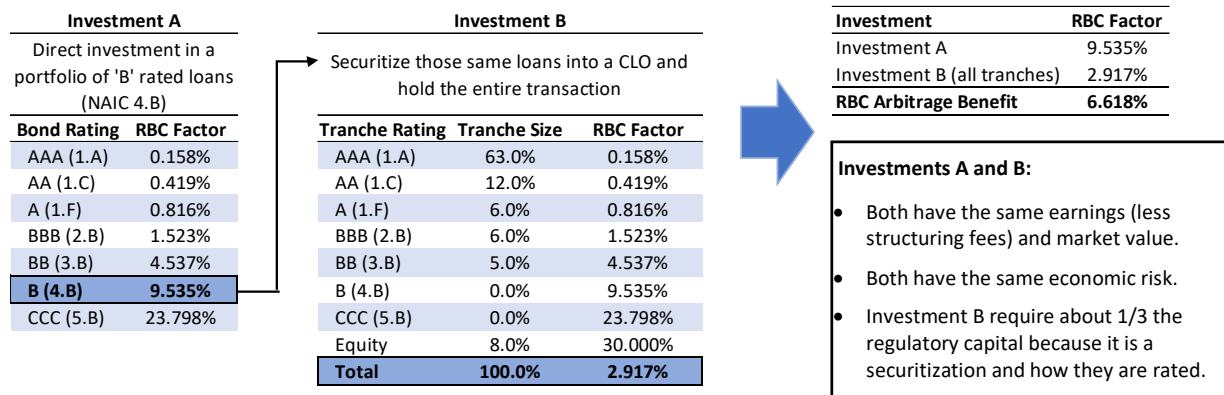
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**Introduction** - A collateralized loan obligation (CLO) is type of structured security backed by a pool of debt, typically corporate loans with low credit ratings. The loans are managed by a collateral manager which bundles the initial loans (generally 150 or more) together and then actively manages the portfolio -- buying and selling loans. To fund the purchase of new debt, the CLO manager sells various tranches of the CLO to outside investors, such as insurers. Each tranche differs based on the order in which the investors will be paid when the underlying loan payments are made. As a result, they also differ with respect to the risk associated with the investment since investors who are paid last have a higher risk of default from the underlying loans. To compensate for the risk, the interest coupon payments on the subordinate tranches are higher. Investors who are paid out first have lower overall risk, but they receive smaller interest coupon payments, as a result.

There are two general types of tranches: debt tranches and equity tranches. Debt tranches are treated just like bonds and typically have credit ratings and coupon payments. Between the debt tranches there is a priority of payments, called a waterfall, by which senior debt tranches are paid before junior, or mezzanine, debt tranches. Equity tranches typically do not have credit ratings and are paid out after all debt tranches on a periodic basis.

**Regulatory Issue** – An insurer that purchases every tranche of a CLO holds the exact same investment risk as if it had directly purchased the entire pool of loans backing the CLO. The aggregate risk-based capital (RBC) factor for owning all of the CLO tranches should be the same as that required for owning all of the underlying loan collateral. If it is less, it means there is risk-based capital (RBC) arbitrage.

It is currently possible to materially (and artificially) reduce C1 capital requirements just by securitizing a pool of assets. This is best illustrated through the following example. Investment A is a pool of corporate loans that would typically comprise a CLO and have a credit rating provider (CRP) rating of 'B'. At a 'B' rating level these investments would be mapped automatically through the Filing Exemption process to an NAIC Designation of NAIC 4.B and receive an RBC factor of 9.535%. Putting those same 'B' rated corporate loans into a CLO divided into six tranches rated AAA, AA, A, BBB, BB and equity, and an insurer buys all of those tranches would result in an overall RBC factor of 2.917%, an RBC arbitrage benefit of +6.618%.



**Recommendation** - The capital required for holding all tranches of a structured security should be consistent with the capital required when holding all of the underlying collateral. As the example above illustrates, there is a significant RBC arbitrage opportunity available today because of the ratings process and the NAIC's RBC factors. The Structured Securities Group (SSG) can model CLO investments and evaluate all tranche level losses across all debt and equity tranches under a series of calibrated and weighted collateral stress scenarios to assign NAIC Designations that eliminate the RBC arbitrage. Highlights of the proposed modeling approach are listed in Appendix A.

The Valuation of Securities (E) Task Force can initiate and approve the assignment of NAIC Designation Categories to CLOs modeled by SSG to eliminate this RBC arbitrage. The Investment Analysis Office staff recommends the Task Force approve staff's request to draft an amendment to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* permitting SSG to model CLO investments.

Staff also recommends the Task Force direct referrals to the Capital Adequacy (E) Task Force (CATF) and its Risk-Based Capital Investment Risk and Evaluation (E) Working Group (RBCIREWG) to request that those groups consider adding two new RBC factors. These new RBC factors can account for the tail risk in any structured finance tranche. Staff suggests adding NAIC Designation Categories (e.g. 6.A, 6.B and 6.C) with recommended RBC factors of 30%, 75% and 100%, respectively.

## Appendix A

### Modeling:

- Starting with the general approach set forth in the [CLO Stress Test Methodology](#), SSG can make the following modifications:
  - Add multiple (8-12) probability weighted scenarios.
  - The probabilities will be derived via an arbitrage free approach such that the  $\sum(\text{asset risk}) = \sum(\text{tranche risk})$  based on current RBC factors.
  - Since tranche performance is non linear, practically this means that SSG can look at a batch of typical deals and set probabilities:  $\sum(\text{asset risk}) = \sum(\text{tranche risk}) \pm 10\%$  or so.
- The process will be transparent and be reviewed periodically.

### Regulatory approach:

- Follow the current RMBS/CMBS approach.
- Annual assessment at year end.
- Publish designations / breakpoints via AVS+ (or similar)

<https://naiconline.sharepoint.com/teams/SVOVOSTaskForce/Shared Documents/Meetings/2022/2022-06-09 - Interim Meeting/05 - CLOs included in Part Four/2022-004.01 - Risk Assessment of Structured Securities - CLOs v3.docx> IAO designations must be used for YE reporting

# Macroeconomic Scenarios for RMBS and CMBS

**Eric Kolchinsky, Director**

June 9, 2022



# Summary

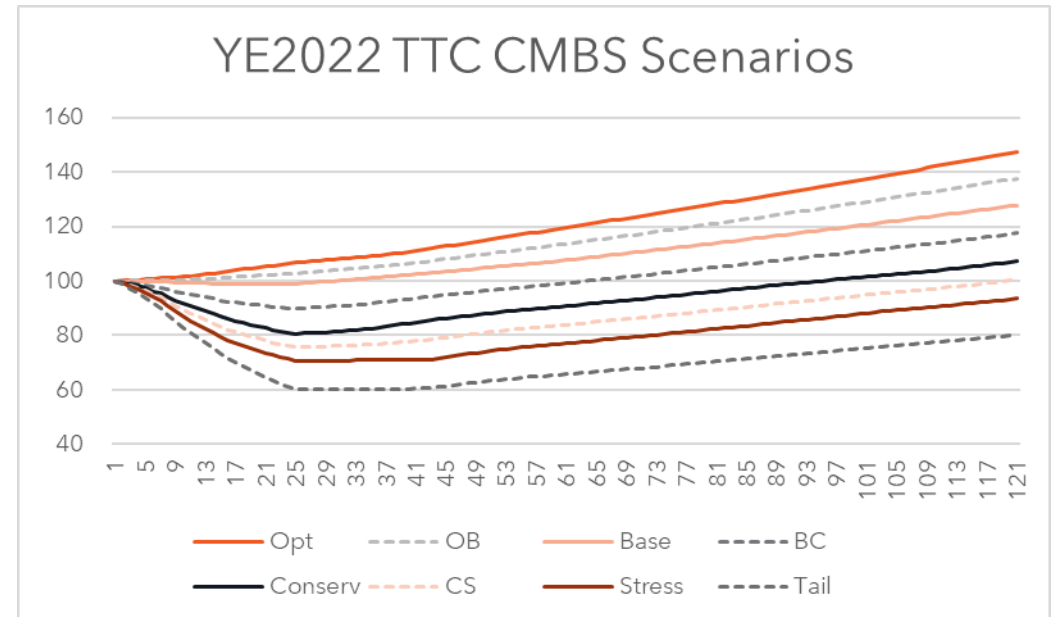
- We are adding additional macroeconomic scenarios in order to better differentiate among 20 Designation Categories.
  - Moving from current 4 scenarios to 8 total scenarios for both RMBS and CMBS.
- These scenarios are meant to be through-the-cycle.
- Work on probabilities has not been finalized, but the intention is to lower the probabilities at the tail and increase at the belly.



# CMBS

- We are adding 3 additional macroeconomic scenarios between the current ones, plus a tail scenario.
- In the table below, the new scenarios (OB, BC, CS and Tail) are in bold.

	Current to Trough	Trough Timing (months)	3yr NPI	5yr NPI	10yr NPI
Opt	N/A	N/A	10%	20%	47%
<b>OB</b>	<b>N/A</b>	<b>N/A</b>	<b>6%</b>	<b>14%</b>	<b>38%</b>
Base	-1%	21	1%	8%	28%
<b>BC</b>	<b>-10%</b>	<b>24</b>	<b>-8%</b>	<b>-1%</b>	<b>18%</b>
Conserv.	-19%	24	-17%	-9%	7%
<b>CS</b>	<b>-24%</b>	<b>24</b>	<b>-23%</b>	<b>-16%</b>	<b>0%</b>
Stress	-29%	24	-29%	-23%	-7%
<b>Tail</b>	<b>-40%</b>	<b>24</b>	<b>-40%</b>	<b>-34%</b>	<b>-20%</b>



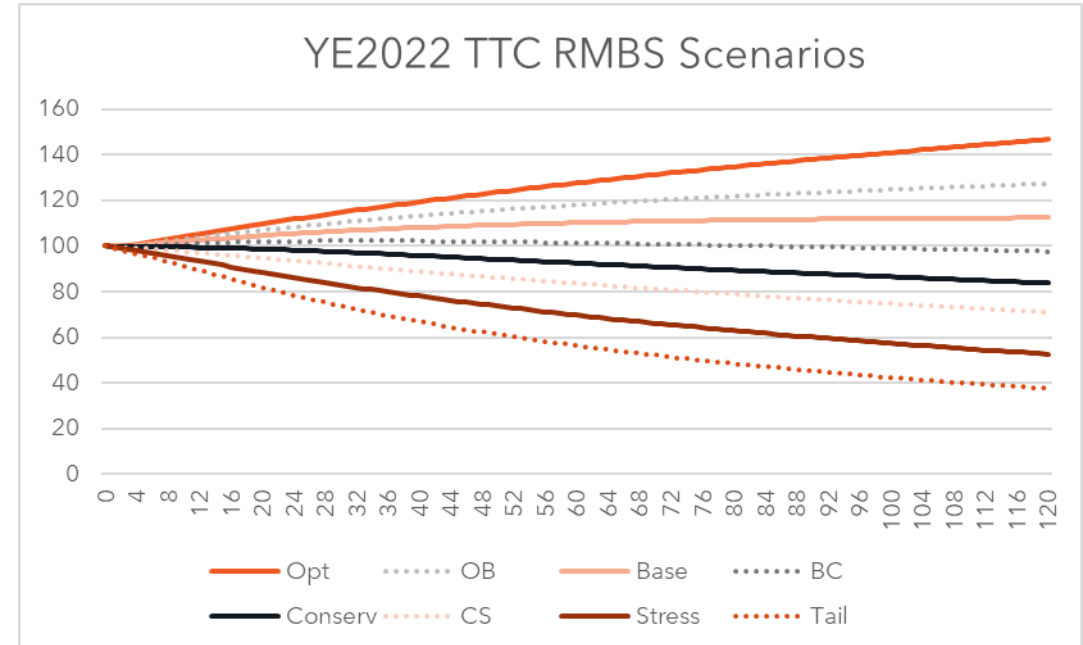




# RMBS

- The process for RMBS is similar – 3 additional scenarios between the current ones, plus a tail scenario.
- In the table below, the new scenarios (OB, BC, CS and Tail) are in bold.

	3yr HPI	5yr HPI	10yr HPI
Opt	18%	28%	47%
<b>OB</b>	<b>12%</b>	<b>18%</b>	<b>27%</b>
Base	8%	10%	12%
<b>BC</b>	<b>2%</b>	<b>1%</b>	<b>-2%</b>
Conserv.	-4%	-7%	-16%
<b>CS</b>	<b>-10%</b>	<b>-16%</b>	<b>-29%</b>
Stress	-20%	-30%	-47%
<b>Tail</b>	<b>-31%</b>	<b>-44%</b>	<b>-62%</b>

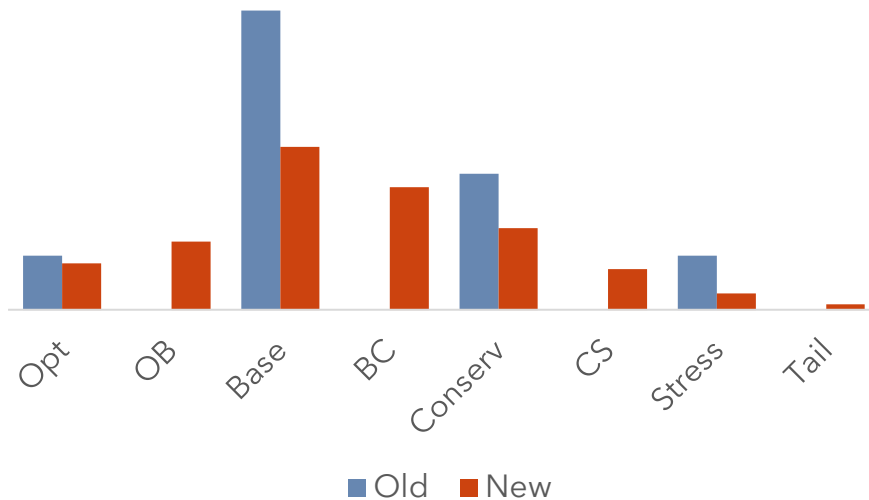




# Probabilities Preview

- Currently finalizing the assignment of probabilities to each macroeconomic scenario. We expect that the final versions will not be too different from below.

CMBS DRAFT Probabilities



RMBS DRAFT Probabilities

